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In our last month's Newsletter we discussed "who must pay estimated tax and the related planning tools". We take up from there to discuss the ways to assess estimated tax, ways of making payment and penalty for underpayment.

Estimating Your Tax

Form 1040-ES, used to pay estimated tax, comes with a worksheet one can use to estimate how much tax one will owe for the current year. Most people don't prefer to use it as it takes them through more detail than may be necessary and is still unable to eliminate uncertainty about the tax liability. The usual way to estimate taxes is comparatively simple:

- We look at each number on the prior year's tax return and ask whether this year's number is likely to be significantly different and disregard differences in wages because there will be a corresponding difference in withholding.
- Now we add up all the differences to see how much more or less our taxable income will be for the current year.
- And then apply the tax rates to see how much difference this will make in our income tax. (If the difference results from a capital gain, we apply the capital gain tax rates.) We can round the number up or tack on an added amount to increase our comfort level about avoiding a penalty.

Many people using this method don't consider changes in tax rates, standard deduction and personal exemptions that result from inflation adjustments. These changes will decrease your tax slightly, so that's one way of providing a cushion of extra payments. Example: Suppose you estimated your 2006 taxable income exactly right, but used the 2005 tax rate schedules to estimate the tax. You would get a refund, because the inflation adjustments for 2006 will result in a lower tax.

Making the Payment

After determining how much you need to pay, you should consider whether to use *estimated tax payments* or *an increase in withholding* to pay this amount.

1) Estimated Tax Payments –There are two ways to figure each payment**.**

a) Regular Installment Method

One of the easiest ways to make quarterly payments is to estimate your total tax liability for the year and divide by four. For nearly all taxpayers, the due date for the first estimated tax payment of each year is April 15 — the same day the *return* is due for the *previous* year. Subsequent payments are due June 15, September 15, and January 15 of the following year. Although they're considered quarterly payments, they're not all three months apart. ***Note that*** if you itemize deductions, it may be to your advantage to make your fourth quarter estimated tax payment in December, not January, so you can deduct it a year earlier.

When you make estimated tax payments you need to enclose Form 1040-ES. It asks for your name, address, social security number and the amount you're paying. You don't have to justify your estimated tax payments. All you're saying is "here's a payment on account. Estimated tax payments don't go to the same address as your return. So, check the instructions for Form 1040-ES for the proper address.

b) Annualized Income Installment Method

If your year's income starts off low and ends up high (say because you have huge fourth-quarter capital gains), you should probably use the "annualized method". This is an exception to the general rule that your four estimated tax payments should be equal. Under the annualized method, estimated payments correspond to your cash flow, so you won't owe big installments on the earlier due dates before you have the money to pay them. Under this method calculation is very complicated, but it sometimes reduces the penalty by a substantial amount. If you use the annualized income installment method to figure your estimated tax payments, you must file Form 2210. But if you don't want to fill out the form, you don't have to do anything until the IRS does the math and sends you a bill.

2) Increasing Your Withholding

In order to increase the amount of federal income tax withheld from your paycheck, you need to file a new Form W-4 with your employer. This form contains several worksheets, and the instructions tell you to "complete all worksheets that apply." You can fill out the worksheets if you want, but there's no particular need if the only thing you're doing is increasing your withholding to cover tax on investment income.

There are two ways to increase your withholding on this form. One is to ***reduce the number of allowances you claim*** on the form. This can be a little complicated, because you don't necessarily know how much your withholding will change when you change your allowances. The amount depends on your income level.

Another way is to ***request an "additional amount" to be withheld from your paycheck.*** This makes it fairly easy to determine the amount of the increase when you file Form W-4. Keep an eye on your paycheck stubs to confirm that the change was properly made and had the effect you anticipated.

There's a special benefit to this approach: extra withholding that comes late in the year is treated the same as if it was spread evenly over the year. You can use this approach to avoid late payment penalties.

Example: Suppose you realize in May that you need to pay $10,000 estimated tax for the year, and you've already blown the first $2,500 payment that was due April 15. You can avoid the penalty altogether by increasing your withholding for the rest of the year by $10,000. This back-loaded withholding can be used retroactively to abate the penalty. This is a real penalty-saving opportunity just for W-2 wage earners.

Penalty for Underpayment

The penalty for underpayment of estimated tax is figured the same as interest. You determine the amount of the underpayment for each period of time and the number of days in that period, and then apply an appropriate interest factor. The interest rate is adjusted from time to time based on market interest rates.

Example: Suppose you make estimated tax payments of $5,000 per quarter, thinking that $20,000 would be enough to cover 90% of your tax liability in a year when the prior year safe harbor wasn't available.

It turns out that $25,000 was required to cover 90% of your tax liability, so you should have paid an additional $1250 per quarter. The amount of your underpayment is $1250 for the period from April 15 to June 15, $2500 from June 15 to September 15, $3750 until January 15, and $5,000 until April 15, 2007 when you file your return with your payment. Assuming that the recently announced rate for underpayments (third quarter of 2006) is 7%, the underpayment penalty would be roughly $234.

The penalty is not deductible, even if it arises because of investment or business income. If you underpay only a small amount, or you correct the underpayment quickly, the penalty will be small.

So you see, even if the estimated–tax rules apply to you, there are easy ways to lessen the pain.

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